

Office of Chief Counsel
Internal Revenue Service

memorandum

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Ammirato

date: March 21, 2002

to: [REDACTED]

from: Area Counsel
(Heavy Manufacturing and Transportation:Edison)

subject: [REDACTED]. **Section 881(a) Tax**

This memorandum supplements the memorandum dated November 6, 2001. Subsequent to issuing the advice on November 6, 2001, additional facts were brought to the attention of our Office. The additional facts change some conclusions reached in the November 6, 2001 memorandum.

FACTS

[REDACTED] Corporation ("taxpayer") entered into a consultant agreement dated [REDACTED] with [REDACTED] Corporation (" [REDACTED]"), a related Taiwanese corporation (brother/sister corporations). The consultant agreement provided that [REDACTED] would perform consulting services on behalf of taxpayer for a fee equal to [REDACTED]% of the operating revenue of taxpayer (" [REDACTED]% payments"). The original agreement further provided that the amount shall be net of any taxes and/or any deductions accrued in the United States. The agreement was amended by an addendum effective beginning on [REDACTED] which provides that the fee shall exclude any taxes accrued in the U.S. (i.e. that any withholding tax, if applicable, would not be withheld but instead would be paid by the taxpayer from its own funds).

The operating revenue of taxpayer was \$ [REDACTED] and \$ [REDACTED] for the taxable years [REDACTED] and [REDACTED], respectively. Taxpayer made payments equal to [REDACTED]% of its operating revenue to [REDACTED] in the amounts of \$ [REDACTED], \$ [REDACTED] and \$ [REDACTED] during the taxable years [REDACTED] and [REDACTED], respectively. Taxes pursuant to section 881(a) were paid by taxpayer in the amounts of \$ [REDACTED] and \$ [REDACTED] for the [REDACTED] and [REDACTED] taxable years on Form 1042 for each year ("section 881(a) taxes").

The section 881(a) taxes were not withheld from the [REDACTED]% payments made to [REDACTED]. In calculating the section 881 taxes, taxpayer took into account the "additional income" to [REDACTED] resulting from

taxpayer's payment of such taxes.¹ Taxpayer deducted the % service fees and the section 881(a) taxes on Form 1120 for each of the taxable years.

In January of [REDACTED], taxpayer filed claims for refund on Forms 1120X for the section 881(a) taxes paid during the taxable years [REDACTED], [REDACTED] and [REDACTED]. Taxpayer argues that the services were performed by [REDACTED] outside the U.S., and, therefore the compensation was not subject to a tax pursuant to section 881(a).²

ISSUE: Whether the claims for refund filed on Forms 1120X constitute timely informal claims for refund for the section 881(a) taxes paid for the periods ending December 31, [REDACTED], December 31, [REDACTED] and December 31, [REDACTED]?

CONCLUSION: Yes.

LEGAL AUTHORITY

A 30% income tax is imposed on the recipient for compensation paid to a foreign corporation where the payment for services is sourced within the U.S. Section 881(a)(1). A payment for services is sourced within the U.S. where the services are performed within the U.S. Section 861(a)(3). A person which makes a payment to a foreign corporation for services within the U.S. is required to withhold the required U.S. tax ("withholding agent"). Section 1441.

A withholding agent must file an annual return of the tax withheld on Form 1042. An original copy of Form 1042 must be filed on or before March 15 of the year following the calendar year in which the tax was required to be withheld. Treas. Reg.

¹It is well established that payment of taxes for a third party is further income to that third party which is subject to further taxes. See Safe Harbor Water Power Corp. v. U.S., 303 F.2d 928 (Ct. Cl. 1962). It appears that taxpayer used the following formula in calculating the section 881(a) tax due:

$$S \text{ (total amount of withholding tax due)} = a(\text{amount of income initially paid}) / 1 - r(\text{withholding rate}) - a.$$
 See Dale, "Withholding Tax on Payments to Foreign Persons" 36 Tax L.Rev. 49, 90 - 91 (1980).

²Only for purposes of this discussion, we assume taxpayer's position is correct. The sourcing issue is being addressed by the audit team.

1.1461-2(b)(1). An information return, Form 1042S, must also be filed which shows certain items paid to a foreign corporation. Treas. Reg. 1.1461-2(c)(1).

Where a withholding agent **over-withholds and deposits** the tax with the Service, the foreign payee and not the withholding agent is entitled to a refund or credit. Section 1464; Treas. Reg. 1.1464-1(a). Where a withholding agent **overpays the tax to the Service but does not over-withhold** from the foreign payee, the Service will credit or refund the overpaid tax to the withholding agent not the foreign payee. Treas. Reg. 1.1464-1. The withholding agent has two options to recover the overpayment (which was not withheld):

1) File a claim for credit or refund of the overpayment in the manner as provided in the regulations under section 6402. Treas. Reg. 1.6414-1(a) (flush language). Treas. Reg. 301.6402-3(a)(4) provides that "[i]n the case of an overpayment of income taxes for a taxable year for which a form other than Form 1040, 1040A or 1120 was filed....a claim for credit or refund shall be made on the appropriate amended income tax return"; or

2) The withholding agent may claim a credit of an overpayment for any calendar year by showing the amount of the overpayment on the return on Form 1042 for such calendar year, which shall constitute a claim for credit. Treas. Reg. 1.6414-1(b).

DISCUSSION

Since the section 881(a) taxes were not withheld from the % payment to [REDACTED], taxpayer is entitled to any credit or refund of such paid taxes. See Treas. Reg. 1.1464-1(a). Of course, a timely claim for credit or refund must be made within the statutory period. Two options for claiming a credit or refund of the taxes were available to taxpayer: 1) showing such amount as an overpayment on Form 1042 filed for such year; or 2) file a claim for credit or refund in a manner provided in section 6402. Treas. Reg. 1.6414-1.

Since the Form 1042 for the respective years has already been filed, option 1 above is not available to taxpayer. Therefore, taxpayer was required to file a claim for refund within three years from the date of filing the Form 1042 pursuant to section 6511.

Pursuant to section 6501(c)(4), taxpayer extended to [REDACTED] (on a Form 872) the period of time for assessment of "any federal income tax due on any return(s) made by or for the ... taxpayer for the periods ended December 31, [REDACTED] and December

31, [REDACTED]". An agreement to extend the period of assessment pursuant to section 6501(c)(4) extends the period for filing a claim for refund or credit to six months after the expiration of the period within which an assessment may be made pursuant to the agreement under section 6501(c)(4). Section 6511(c).

Section 881(a) imposes a tax on income of a foreign corporation. As a withholding agent, taxpayer is required to pay such income tax on Form 1042. In our facts, the section 881(a) income taxes at issue were for the periods ended December 31, [REDACTED], December 31, [REDACTED] and December 31, [REDACTED]. Form 872 executed by taxpayer extended to [REDACTED] the statute of limitations on assessment of **any income tax due on any return made by taxpayer** for the [REDACTED] and [REDACTED] years. Therefore, the statute of limitations for taxes due on Forms 1042 (as well as the taxes due on Forms 1120) for [REDACTED] and [REDACTED] was extended to [REDACTED]. As such, pursuant to section 6511(c) the period for filing a claim for refund for the 881(a) taxes for the period ended December 31, [REDACTED] and December 31, [REDACTED] expires on [REDACTED]. Therefore, the claim for refund filed in January of [REDACTED] for taxes paid on Form 1042 for periods ended December 31, [REDACTED] and December 31, [REDACTED] was timely.

The period of limitation for filing a claim for refund for taxes reported on Form 1042 for the tax year ended December 31, [REDACTED] expired on [REDACTED] (3 years from due date of return). Therefore, the claim for refund filed in January of [REDACTED] for taxes paid on Form 1042 for the tax year ended December 31, [REDACTED] was also timely.

In our facts, taxpayer filed the claims for refund for section 881(a) on Form 1120X. Although the claims for refund were timely, taxpayer was required to file the claims on a Form 1042 and not a Form 1120. Although filed on incorrect forms, the claims should be treated as valid informal claims for refund. The validity of informal claims for refund have long been recognized. See United States v. Kales, 314 U.S. 186 (1941). In order to be valid, an informal claim must be clear in alerting the Commissioner that a refund of taxes is sought for certain years. Missouri Pacific R.R. v. United States, 214 Ct. Cl. 623, 627 (1977). A claim is valid where "the Commissioner knew, or should have known, that a claim was being made." Newton v. United States, 143 Ct. Cl. 293, 300 (1958). In our facts, the claims were clear and unambiguous, therefore, they constitute valid informal claims for refund.

Please note, in the memorandum dated November 6, 2001 we stated that the extension of the period for filing a claim for refund or credit of Form 1120 income taxes does not extend the period for filing a claim for refund of taxes paid on Form 1042. While this

statement is generally true if the withholding agent is a subsidiary of the taxpayer (which is common for a consolidated group) it does not apply under the facts of this case. A Form 872 extending the statute of limitations for taxes reportable on a Form 1120 for a consolidated group would not extend the statute of limitations for taxes reportable on a Form 1042, where the withholding agent is not the parent corporation executing the Form 872. However, in our facts the Form 872 extends the statute of limitations on the assessment of any income taxes due on any return made by taxpayer. Furthermore, the Form 872 was executed by the taxpayer, who was the withholding agent. Therefore, the Form 872 extends the period for filing a claim for refund of taxes paid on the Form 1042 by taxpayer, as well as any income taxes paid on Form 1120.

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If you have any questions please contact Assoc. Area Counsel William F. Halley at (973)645-3348.

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